

**A Perspective on U.S. and Global Capital and Trade Imbalances,
and the Foreign Accumulation of U.S. Debt**

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“Foreign Holdings of U.S. Debt: Is Our Economy Too Vulnerable?”

Committee on the Budget
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- The debate about the high U.S. trade and current account imbalances—and worries about their dire consequences—has been going on for decades. Long-standing concerns that these imbalances will severely damage U.S. economic and financial performance have not unfolded and are overstated. The foreign capital inflows have fueled U.S. economic growth, and contributed to job creation and business investment, homeownership and higher standards of living. The large U.S. current account deficit and foreign accumulation of U.S. debt will not unhinge the U.S. economy, as long as international trade and capital are allowed to flow freely, the U.S. dollar is allowed to fluctuate and the U.S. policymakers continue to pursue low inflation pro-growth economic policies.
- The debate about fiscal policy should not be influenced by the debate about the U.S. current account deficit. Sustained healthy economic performance requires coming to grips with the long-run Federal budget imbalance, which requires reforming the entitlement programs by making their benefit structures economically rational and fair. Delaying necessary reform only increases the eventual cost of adjustment. Fiscal reform must focus on improving U.S. government finances and making them conducive to maximum sustainable economic growth. Efforts to adjust fiscal policy to reduce the current account deficit without regard to how changes in the structure of the underlying tax and spending programs would affect economic performance are unwise and could generate unintended and undesirable economic and financial side effects.
- History shows that budget imbalances and current account imbalances do not move in tandem in the U.S. or overseas. The so-called “twin deficit” framework is not a rational basis for conducting fiscal policy or for thinking about global imbalances. Currently, the U.S. budget deficit is 1.3 percent of GDP while its current account deficit is 5.6 percent; both Japan and Germany have large current account surpluses (3.9 percent and 5.1 percent, respectively) despite running budget deficits (Japan’s is 5.8 percent of GDP).
- The U.S. trade and current account imbalances and the large current account surpluses overseas and the large net accumulations of foreign holdings of U.S. debt have been a natural consequence of global differences in rates of economic growth, investment and saving. From the early 1990s through 2005, the U.S. economy expanded significantly more rapidly than other industrialized nations, raising demand for capital and imports. The U.S. has insufficient national saving relative to investment. Until recently, foreign industrialized nations have grown more slowly, both in terms of GDP and investment, dampening their demand for imports and capital. China, other Asian nations and more recently, OPEC nations as well as Russia, benefiting from higher oil prices, have excess saving relative to investment. The capital inflows into the U.S. from excess saving nations—largely through their accumulation of U.S. debt—provide the U.S. capital necessary to continue healthy economic expansion.
- Foreign assets owned by the U.S. have risen, but U.S. assets owned by foreigners have risen more rapidly, so the U.S. net foreign debt is \$2.5 trillion. U.S. ownership of foreign assets is heavily in equity and direct investment, which provides relatively high returns, while foreign investment in U.S.

assets is largely in U.S. debt securities, which provide relatively low yields. Consequently, the U.S. net international income position is near balance.

- Foreign investors, including Asian central banks, which have accumulated over \$2 trillion of foreign currency reserves, voluntarily invest their surpluses heavily in U.S. assets. Their investment decisions are economically rational: they are attracted by the U.S.'s rule of law and historic stability; healthy economic performance and relatively high real interest rates; low inflation and credible central bank; and liquid markets. Excess saving nations benefit just as much from their investments in U.S. dollar denominated assets as the U.S. benefits from the net foreign capital inflows. U.S. and global economic growth and standards of living are improved by capital that flows internationally from excess savers to high expected rate of return activities.
- Decades-long worries that foreign investors will abruptly sell their U.S. assets are misplaced. Such concerns tend to ignore the objectives and needs of excess savings nations, and what drives their investment decisions and behavior. Foreign investors, including central banks, seek high risk-adjusted rates of return. Foreign nations that have accumulated U.S. debt will not shift out of dollars quickly in a way that would jar financial markets unless there is a dramatic shift in economic fundamentals, or shifts in U.S. policies perceived to be damaging to U.S. economic or financial performance. A jarring shift out of U.S. dollars likely would damage foreign owners of U.S. assets as much as it would damage the U.S.
- Financial variables that are crucial to sound U.S. economic performance, including interest rates, corporate bond yields, the stock market and foreign exchange rates, are driven primarily by fundamental U.S. and global trends in economy and profits, inflation, and central bank and fiscal policy. Investment decisions by foreign holders of U.S. assets may temporarily affect financial markets, just as decisions by U.S. investors do, but they do not influence Fed behavior or inflation or how the U.S. economy performs.
- Foreign investors are subject to many of the same economic, inflation and financial market fluctuations as U.S. investors. Their investment behavior is at least as stable as that of U.S. investors, and their ownership of U.S. assets does not raise the risk or vulnerability of U.S. economic and financial market performance any more than if those assets instead were owned by U.S. pension funds, money managers or hedge funds.
- Concerns that the recent decline in the U.S. dollar will push up U.S. inflation and damage financial markets and the economy are misplaced as long as the Federal Reserve pursues a credible low inflation monetary policy. Under a low inflation monetary policy regime, even if the U.S. dollar continues to fall, relative prices would change, and real interest rates may rise modestly, but inflation would not be pushed up. It is inappropriate and misleading to assert that current U.S. dollar weakness will have a similar impact as the 1970s when the Fed was pursuing an inflationary monetary policy.
- The U.S. trade and current account deficits have begun to recede from their peaks, and I expect they will decline materially, particularly as shares of GDP. The U.S. demand for capital and imports has slowed in response to the recent soft-patch in U.S. domestic demand, while its exports are growing rapidly, driven by strong global growth and the weak U.S. dollar. The economic momentum in Japan and Europe (particularly Germany), which reflects in part structural improvements, is narrowing economic growth differentials among industrialized nations and increasing expected rates of return on Euro- and yen-denominated assets. Accordingly, the growth of foreign demand for U.S. assets has slowed, while the U.S.'s financing gap between national saving and investment has begun to recede.
- The government's net costs of servicing debt owned by foreigners have been low, and concerns are misplaced. My largest concerns are not the magnitude of the global imbalances or the foreign accumulation of U.S. government debt, rather the potential for wrongheaded policies that would interrupt international trade or capital flows, or domestic policies that would damage U.S. growth prospects and reduce expected rates of return on U.S. dollar-denominated assets.

Notes on the Wide U.S. and Global Imbalances

If the U.S. and other major nations had similar rates of economic growth, investment and saving, global imbalances would be minor. But they do not. The rising U.S. current account imbalances are largely the story of the relatively stronger U.S. growth from 1990-2005 and global demand for U.S. assets. This has happened before; the U.S. has experienced long periods of relative economic strength simultaneous with large net capital inflows and wide current account imbalances (the best example is the U.S. industrial revolution). In recent decades, periods of rising current account deficits have been associated with strong growth in GDP, investment and jobs, and rising homeownership. This should not come as a surprise: foreign capital flows into the U.S. when it is strong, investment and employment are rising and expected rates of return are high. The only periods recently when the U.S. trade and current account deficits declined occurred when GDP slumped and employment fell.

From the early 1990s, when the U.S. current account was in balance, through 2005, the U.S. economy grew persistently faster both in terms of nominal and real GDP growth and investment than all other industrialized nations (see Chart 1). The growth differentials were sizable and cumulative. Consequently, U.S. imports of goods and services rose significantly faster than foreign demand for U.S. exports, and demand for U.S. assets rose, so the U.S. current account deficit rose commensurately (see Charts 2 and 3). Until recently, the economies of Germany and Japan languished, and so did their imports. Reflecting this, they ran high trade and current account surpluses. That is, they had excess saving relative to investment, and were unattractive to foreign investment flows.

Noteworthy, Japan has run high current account surpluses, despite huge government budget deficits. Its budget deficit is nearly four times higher than the U.S.'s and its government debt is approximately 170 percent of GDP, more than four times higher than the U.S.'s 37 percent. This is not surprising: for over a decade, Japan's economy and investment languished, and it attracted little foreign capital inflows; its saving far exceed investment and it was a sizeable exporter of capital. Devotees of the so-called "twin deficit" paradigm should heed the message provided by this international comparison.

The composition of U.S. imports illustrates the strength of U.S. businesses as well as consumer spending growth: presently, 40 percent of U.S. goods imports (and 33 percent of total U.S. imports of goods and services) are industrial supplies and capital goods used for business production and expansion (see Chart 4). Those shares rose during the 1990s. It is inappropriate and misleading to place all of the blame on the U.S. consumer for rising imports and trade and current account deficits.

The rising current account deficit in the 1990s illustrates both the widening gap between U.S. investment and saving, and the strong foreign demand for U.S. dollar-denominated assets. They both occurred simultaneously: as global demand for U.S. assets rose—modestly through the mid-1990s and then jumping during the 1997 Asian crisis—capital availability and rising asset prices fueled U.S. domestic demand. Consumption and business investment rose rapidly—and U.S. saving fell further behind surging investment. The U.S. current account deficit, which rose to approximately 1.5 percent of GDP by mid-1997, jumped dramatically to 4.5 percent by year-end 2000 (see Chart 3). Yet the U.S. dollar appreciated even as the current account deficit rose because foreign capital readily flowed into the U.S. seeking high risk-adjusted rates of return.

The rate of net national saving was flat during the 1990s, as high business saving and a shift from the government's cash flow deficit to surplus was offset by the declining rate of personal saving. Despite the lower rate of personal saving, the real net worth of households was rising with the appreciation of real estate and the stock market. Households felt richer and more confident and so they spent a larger portion of their take-home pay. The rate of personal saving, which only measures the portion of disposable personal income that is spent, does not capture appreciation of real estate or stocks or bonds, and as such is a very limited—and misleading—measure of saving.

New Dimensions in Global Imbalances. The trends in global trade and current account imbalances so far this decade reflect new dimensions in global economic performance and international trade and capital flows. First, the U.S. recession in 2001 and associated slump in investment and domestic demand that carried into 2002 reduced the demand for imports, which temporarily lowered trade and current account deficits. Import growth subsequently resumed, contributing to a surge in the trade deficit through

2005. While the trade imbalance has continued to rise in nominal terms, in real terms it has begun to drift down, and as a percent of GDP, it peaked at 5.7 percent in 2005Q1 and has receded to 5.3 percent in 2007Q1. This reflects in part slower import growth since early 2006 that has been associated with weaker consumer and business spending growth in response to the Fed's interest rate hikes and the adjustment in housing.

Second, global economic growth has strengthened and international trade has been growing rapidly. U.S. exports have risen over 8 percent annualized, and the U.S. remains the world's largest exporter of goods and services. The U.S. maintains a healthy "competitive edge" in a wide array of industries, and is well positioned, both in terms of what it exports and to where it exports, for export growth to remain strong (see Charts 5 and 6). Importantly, the economic momentum in Japan and Germany reflects structural improvements that will sustain healthier growth. These trends abroad are contributing to narrower economic growth differentials among industrialized nations, and increasing the attractiveness of investing in Europe and Japan. In turn, they will serve to narrow global imbalances.

Third, Asian nations have been large net savers and have accumulated foreign currency reserves at an historic pace (see Tables 1 and 2). Combined they have become the world's largest exporters of capital, which is a twist on history insofar as some of them, most notably China, are relatively poor nations in terms of GDP per capita but also growing rapidly. The largest portions of their surpluses have been invested in U.S. debt securities.

Fourth, China has emerged as a dominant global factor in both international trade and finance. As a major manufacturing hub that imports supplies and materials, and produces and exports finished products, it runs trade deficits with most other Asian nations, and huge trade surpluses with the U.S. (presently, approximately \$220 billion) and Europe. Benefiting from its surging trade surpluses, high foreign direct investment and extraordinarily high rate of saving, China has accumulated approximately \$1.2 trillion in currency reserves.

Fifth, benefiting from the dramatic rise in oil prices since 2004, OPEC nations and Russia have become large excess savers. In the last several years, the cumulative rise in surpluses by these nations has been dramatic (see Table 3). The fact that global oil transactions are conducted in U.S. dollars is a key factor explaining the large share of these surpluses that have been accumulated in U.S. dollar-denominated assets.

Stronger growth in Europe and Japan, and more moderate growth in U.S. domestic demand, and associated narrowing in real interest rates (as the European Central Bank and Bank of Japan have continued hiking rates, narrowing the gap with the Federal funds rate) and expected rates of return on investment will generate a narrowing of the U.S. trade and current account deficits.

Notes on the Foreign Accumulation of U.S. Assets

U.S. economic and financial performance has benefited from the nation's ability to run high current account deficits. The economy is no more vulnerable as a result of the foreign accumulation of U.S. debt than if that debt were owned by U.S. pensions, money managers or hedge funds. Reliance on net foreign capital inflows allows the U.S. to leverage its resources and economic strengths. If U.S. investment were constrained to national saving, there would be insufficient investment, and economic growth, job creation and standards of living would be lower. Similar to U.S. corporations that borrow to leverage their resources and expansion, the key to the sustainability of the current account deficits is what the net capital inflows are used for and what is the rate of return on the capital relative to the costs of financing it. Historically, the benefits have far exceeded the net costs.

The majority of U.S. assets owned by foreign investors are debt securities, primarily U.S. government and agency debt (see Charts 7 and 8). This is particularly true of U.S. assets held by foreign central banks. While foreign holdings have increased substantially as a share of outstanding U.S. government debt, foreign purchases of U.S. equity and direct investment are minor relative to the dramatic rise in household and corporate net worth (see Chart 9). According to the Federal Reserve's *Flow of Funds Accounts of the United States* and the Bureau of Economic Analysis, foreign ownership of U.S. equity assets and direct investments total \$4 trillion, compared to U.S. household net worth of \$56.2 trillion.

Rather than be concerned about the increased foreign ownership of U.S. government debt, Congress should be thrilled with the highly favorable outcome: the government's real costs of servicing the debt have been very low, and the capital inflows have facilitated stronger U.S. economic growth. So far this decade, when foreigners have accumulated U.S. government debt rapidly, yields on U.S. government bonds have been below their longer-run average in nominal and real terms. The real government bond yields have been far below real GDP growth, while profits and real household net worth have grown significantly faster than output and the unemployment rate has receded. Clearly, the net returns on the foreign purchases of U.S. government debt have been highly favorable.

Foreign purchasers of U.S. government bonds generally have not fared as well. Foreign holders of U.S. government debt receive a yield on their bonds with virtually no credit risk but they do have interest rate and currency risk. In reality, they do not own claims on future U.S. economic performance. Although yields on U.S. government bonds have been significantly higher than yields in other industrialized nations, net real returns to foreign purchasers of U.S. government debt have been reduced by the decline in the U.S. dollar. In contrast, foreign purchasers of U.S. private assets—bonds, equity or direct investments—own claims on returns from U.S. production, and have enjoyed higher rates of return. A reallocation of foreign owned U.S. assets away from government debt and into equities and direct investments would generate higher returns but would involve higher risks.

U.S. purchases of foreign assets, in contrast, have provided substantially higher yields, based on the significantly heavier weighting in equity and direct investments, sharply appreciating global asset values, and the decline in the U.S. dollar.

Concerns about heightened economic vulnerability arising from foreign accumulation of U.S. government debt hinge in part on an assumption that foreign investors have significantly different objectives than U.S. investors. In reality, their objectives are similar: they seek high expected rates of return on a risk-adjusted basis. They base their investment decisions on the same fundamentals as U.S. investors: indicators of economic performance, inflation, expectations about Federal Reserve behavior, and the soundness of fiscal policy. They have little sway over how those variables behave. In practice, particularly in the case of foreign central banks, foreign holders of U.S. debt tend to be less leveraged and more "buy and hold" type of investors than their U.S. counterparts.

I am hard-pressed to see any heightened vulnerability arising from foreign ownership of U.S. debt. Expectations of a sharp decline in the U.S. dollar would temper the foreign demand for U.S. assets. However, U.S. bond yields exceed those in other major industrialized nations (except the UK), and U.S. markets are attractive for other reasons. Over time, if overseas industrialized nations maintain their healthy economic expansions, and as financial markets in emerging nations mature and become more liquid, foreign investors may gradually reduce their shares of assets allocated into U.S. dollars. That is not a cause for alarm. As long as U.S. economic performance remains sound, the Fed maintains its inflation-fighting credibility and other policies are conducive to healthy growth, foreign demand for U.S. government debt will remain healthy.

Notes on U.S. Fiscal Policy

The primary problems with Federal government finances are not short-term cash flow issues. The Federal budget deficit is estimated to be approximately 1.3 percent of GDP in Fiscal Year 2007. Tax receipts have risen above 18.5 percent of GDP, modestly above their long-run average, and spending growth has slowed. The Congressional Budget Office projects that under current law, the budget returns to surpluses. Presently, despite the enormous jump in defense and national security spending, the U.S. budget deficit is among the lowest of all industrialized nations, and U.S. government debt as a percent of GDP is far below other nations (see Charts 10 and 11). With the U.S. deficit declining as a share of GDP and well below government interest rates, the debt/GDP ratio is projected to decline in the near term.

However, the longer term outlook for government finances is distinctly negative. Top fiscal policy priorities are entitlement reform, which is necessary to close the long-run gap posed by the unfunded liabilities of the government's retirement and health care programs, and tax reform. Based on current law benefit and tax structures and reasonable economic and demographic assumptions, the long-run projected unfunded liabilities of the social security and Medicare systems are so enormous—the present value of the gap between projected long-run benefits and taxes is estimated to be approximately 6

percent of GDP—that reform requires modifying benefit structures to make them economically rational. Tax hikes to close the gaps would be so large they would damage economic performance.

Fiscal policy decisions about the entitlement programs must be made based on sound economics, and not arithmetic modifications to long-run projections that ignore the allocative impacts of the tax and spending changes. Changes to social security must be phased in so that older workers have time to adjust their retirement plans, and they must be fair. American citizens expect eventual reform because they sense that the current benefit structure cannot be sustained. Congress's credibility will rise when it successfully tackles the issue. Reforms of Medicare and Medicaid are even more imperative and will be more difficult to achieve. Successful reform necessarily will involve the introduction of incentives that influence the supply of and demand for medical services.

Tax policy must deal with the unintended, increasing burden imposed by the Alternative Minimum Tax, the extraordinarily burdensome complexity of the personal and corporate tax systems and the phasing out of key provisions of the 2001, 2002 and 2003 tax legislations.

The details of both entitlement and tax reform are far beyond the scope of these hearings. But the starting point for success requires that fiscal reform must be aimed at improving the government's domestic finances consistent with sustained healthy economic performance, and not for the explicit purpose of trying to reduce the current account deficit. The U.S. current account is affected by numerous factors beyond the scope of fiscal policy—including differing rates of economic growth, investment and saving around the world, demographics, and inflation—which explains why there is no reliable linkage between budget imbalances and current account imbalances. I encourage Congress to pursue sound fiscal policies that will strengthen long-term U.S. economic performance, and to reassess the premises of many concerns about the U.S. current account deficit and the holders of government debt.

Chart 1: Economic Growth Advantage
(U.S. real GDP % Chg versus Eurozone & Japan)

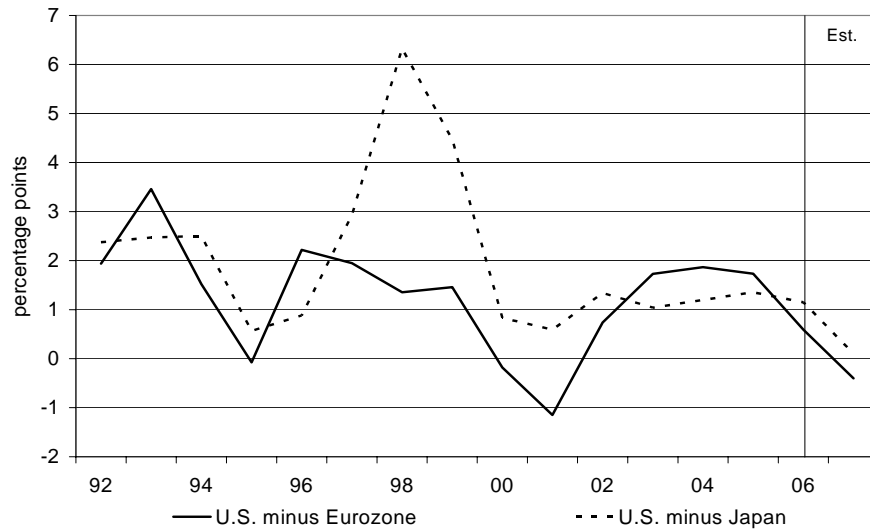


Chart 2: Real U.S. Exports & Imports

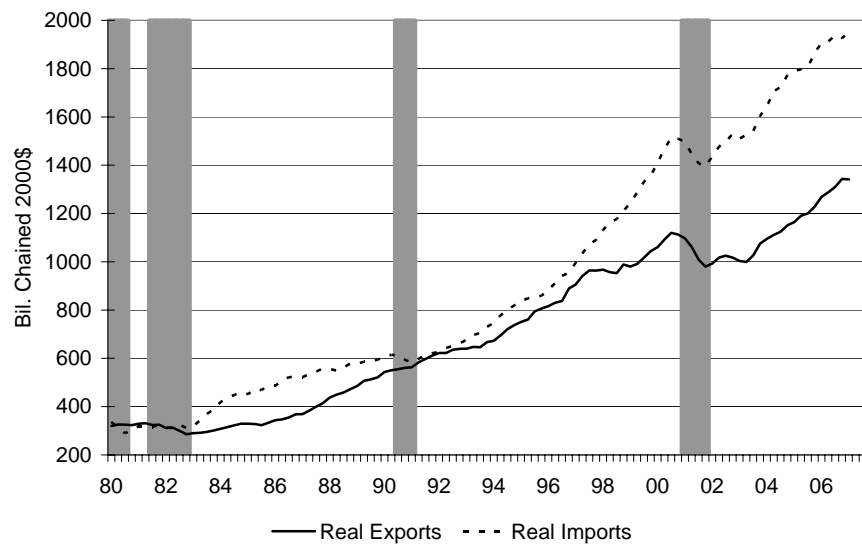
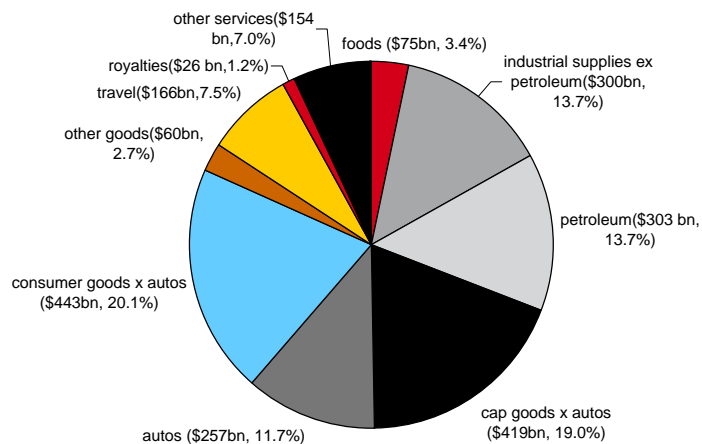


Chart 3: U.S. Trade & Current Accounts (as a percent of GDP)

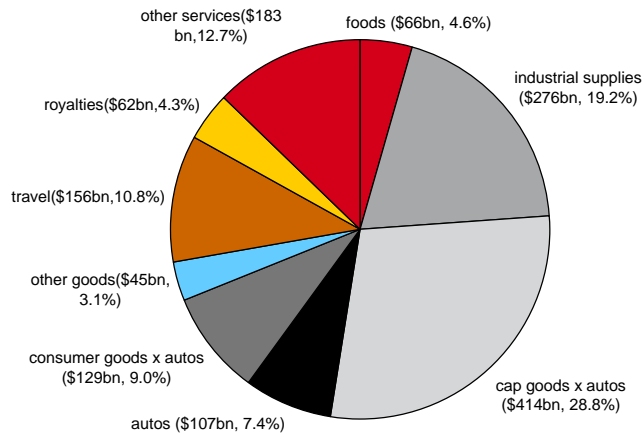


Chart 4: Composition of U.S. Imports (2006 \$2.2 trillion)



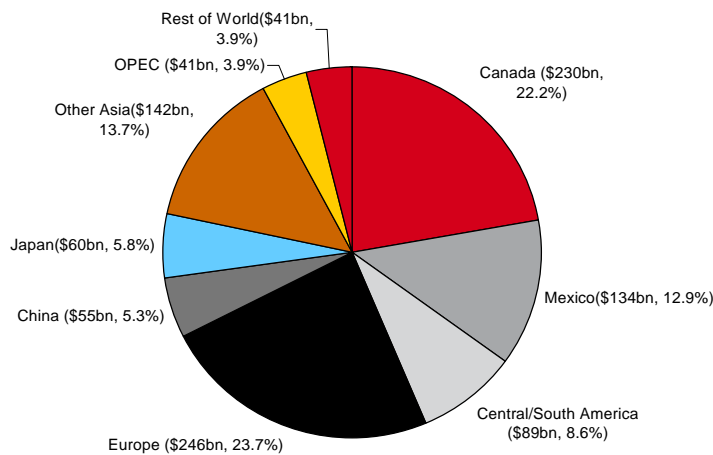
First term is value of nominal imports, second term is share of imports
Source: Census Bureau/Haver Analytics/Bank of America

Chart 5: Composition of U.S. Exports (2006 \$1.4 trillion)



First term is value of nominal exports, second term is share of exports
Source: Census Bureau/ Haver Analytics/Bank of

Chart 6: Distribution of U.S. Goods Exports (2006 \$1.0 trillion)



First term is nominal goods exports, second term is share of nominal goods
Source: Census Bureau/ Haver

**Table 1: Global Saving & Investment
(Percent of GDP)**

	1985-2000	2001	2006
World			
Saving	22.4	21.2	22.8
Investment	23.0	21.4	22.8
United States			
Saving	16.8	16.4	13.7
Investment	19.4	19.1	20.0
Euro area			
Saving	21.4	21.3	21.3
Investment	21.1	21.0	21.3
Japan			
Saving	31.8	26.9	28.0
Investment	29.2	24.8	24.1
Newly Industrialized Asian Countries			
Saving	34.5	30.0	31.3
Investment	29.9	25.3	25.7
Middle East			
Saving	20.5	27.3	40.4
Investment	22.4	21.2	22.5
Other EM & Developing Countries			
Saving	24.2	24.6	31.8
Investment	25.5	24.0	27.4

Source: IMF World Economic Outlook Database

**Table 2: Accumulated Currency Reserves
(April 2007; Total Reserves excluding Gold)**

Country	Billions U.S.\$
Japan	899.0
China (Feb 2007)	1159.4
Other Asia (Feb 2007)	976.0
Russia	360.4
OPEC (Year end 2006)	331.5
Euro area	204.2

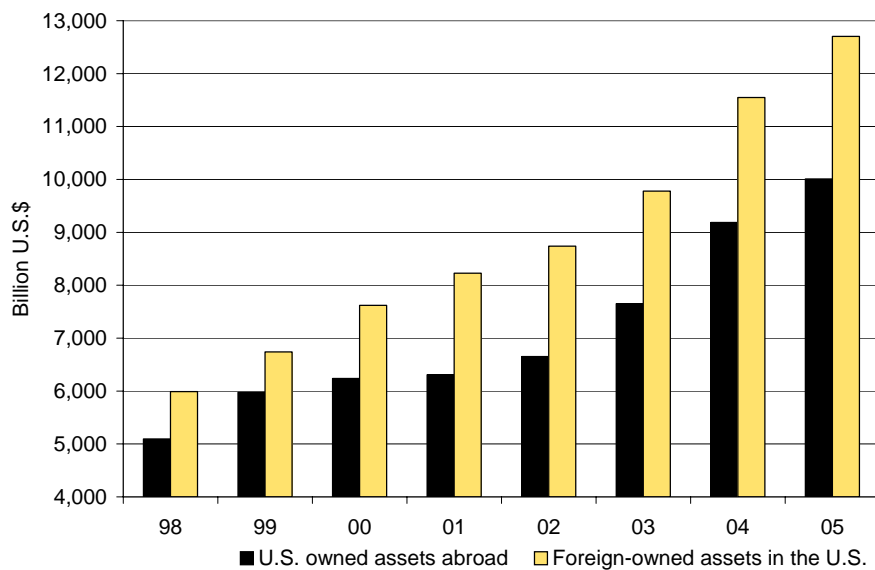
Source: International Monetary Fund

Table 3: Selected Countries with Large Current Account Imbalances (2006)

Country	Current Account as a % of GDP
United States	-6.1
United Kingdom	-3.0
Spain	-8.8
Australia	-5.3
China	8.1
Japan	4.0
Russia	5.7
Saudi Arabia	18.2
Germany	4.9

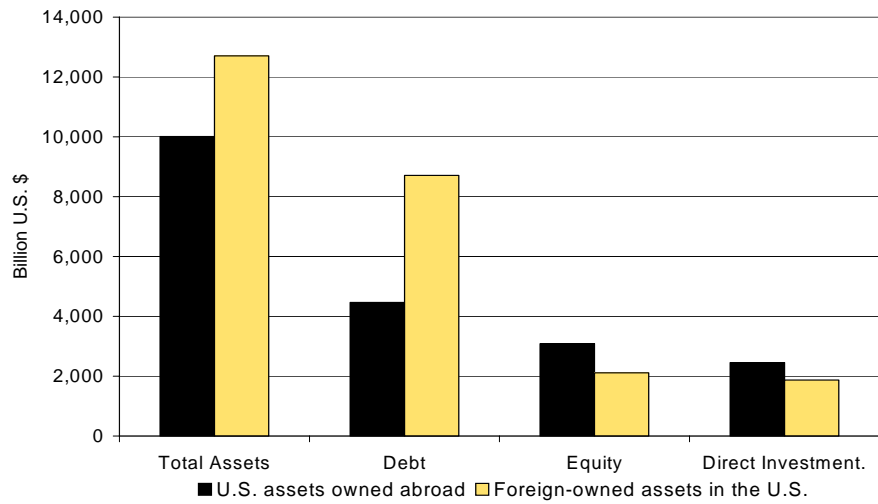
Source: Economist Magazine

Chart 7: U.S. International Asset Position



Source: Bureau of Economic Analysis/Haver Analytics

**Chart 8: U.S. Net International
Asset Position
(at year-end 2005)**



**Chart 9: Foreign Holdings of U.S. Equity Assets
& Direct Investments Relative to U.S. Net Worth**

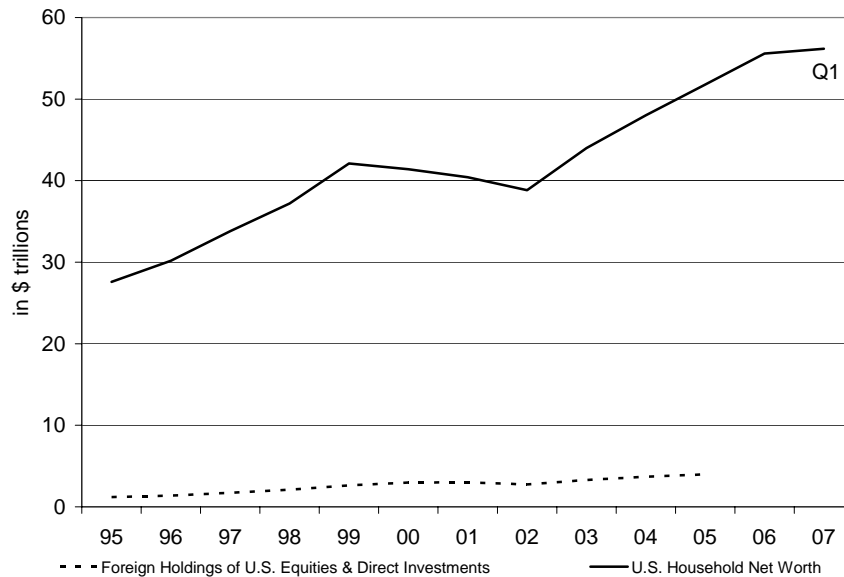
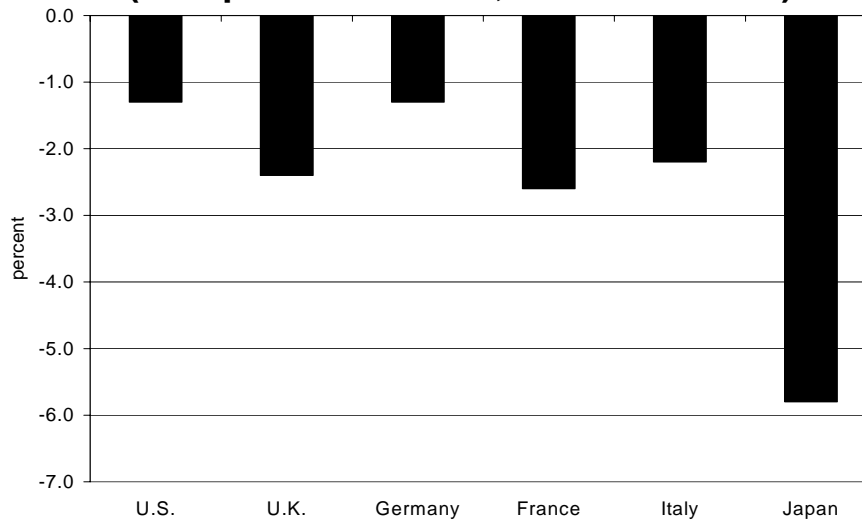
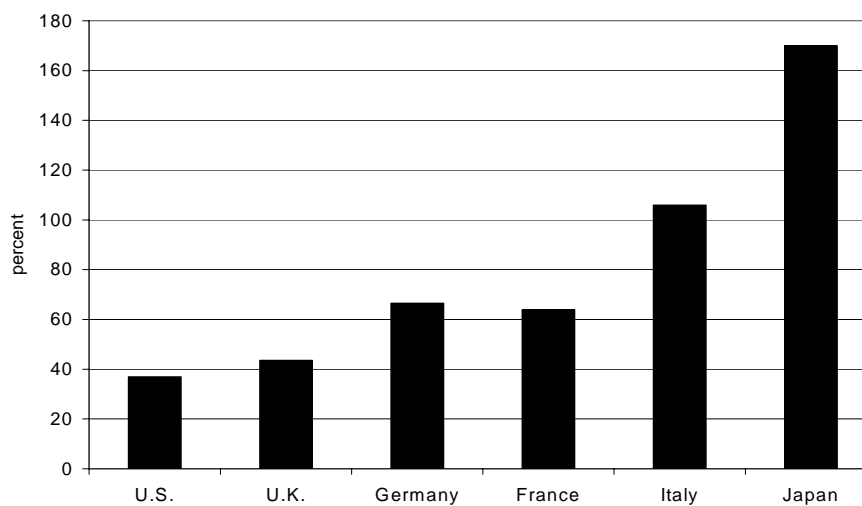


Chart 10: International Comparison of Budget Deficits
(as a percent of GDP, 2007 estimates)



Source: IMF World Economic Outlook Database/CBO/Haver Analytics

Chart 11: International Comparison of Government Debt/GDP
(as a percent of GDP, 2007 estimates)



Source: IMF World Economic Outlook Database/Haver Analytics/Bank of America Estimates

Committee on the Budget
Witness Disclosure Requirement – “Truth in Testimony”
Required by House Rule XI, Clause 2(g)

Your Name: <u>Mickey D Levy</u>		
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the committee).	Yes	No <input checked="" type="checkbox"/>
2. Please list any federal grants or contracts (including subgrants or subcontracts) which <u>you have received</u> since October 1, 2003: <p style="text-align: center; font-size: 1.2em;">None</p>		
3. Will you be representing an entity other than a government entity?	Yes	No <input checked="" type="checkbox"/>
4. Other than yourself, please list what entity or entities you will be representing: 		
5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4: 		
6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 2003, including the source and amount of each grant or contract: 		
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list:	Yes	No <input checked="" type="checkbox"/>

Signature: Mickey D Levy Date: June 21, 2007

Please attach this sheet to your written testimony.